In the Administration's 1999 budget proposal, the President proposed modifying these rules by requiring a partnership to adjust the basis of its assets following the distribution of property to a partner. The proposal would require the partnership to increase the basis of its remaining property by the excess of (1) the amount of money and the basis the property distributed, over (2) the amount by which the distributee partner's share of the partnership's basis in its assets and money is reduced by the distribution. The partnership would reduce the basis of its property by the excess of the amount in (2) over the amount in (1).

Under the Administration's 1999 budget proposal, the adjustment to basis would be made to the basis of the partnership's nondepreciable capital assets held after the distribution. The description of the proposal specifically notes that "unrealized receivables" are included in the term nondepreciable capital asset. If the required positive basis adjustment cannot be made because the partnership does not own any nondepreciable capital assets, then the partnership will recognize a long-term capital loss. In the case of a required negative adjustment, the adjustment is first made to the basis of nondepreciable capital assets, and then to the basis of other assets. If the partnership cannot make the required adjustment because it has insufficient basis in its assets, the partnership would recognize a long-term capital gain.

Under the Administration's 1999 budget proposal, the proposed changes would be effective for distributions made after the date of enactment and, consequently, would have no effect on the Transactions.

G. Contribution to Corp

1. Code Section 351

Code Section 351(a) generally provides that no gain or loss is recognized by a transferor of property to a corporation in exchange for its stock, if that transferor together with any other persons transferring property to the corporation as part of the same transaction control the transferee corporation immediately after the exchange. "Control" for this purpose means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of each other class of stock. Code Section 368(c). It is not necessary for shares of stock to be actually issued, where as in the instant case, all of the contributing shareholders contribute property to the corporation in proportion to their interests therein. See, Lessinger v. Comm'r, 872 F.2d 519 (2d Cir. 1989). Furthermore, it is more likely than not that the Financial Assets would be treated as property for

this purpose. Rev. Rul. 81-4, 1981-1 CB 126. Cf., Holstein v. Comm'r, 23 T.C. 923 (1955). Consequently, because Investor owns 100% of the issued and outstanding stock of Corp, it is more likely than not that Investor's contribution of the Financial Assets to Corp would generally qualify as a contribution subject to Code Section 351(a).

Notwithstanding that the contribution generally meets the requirements of Code Section 351(a), Code Section 351(e) provides that Code Section 351(a) does not apply to a transfer of property to an investment company. Notwithstanding such broad language, Treas. Reg. §1.351-1(c)(1) provides that a transfer will be considered to be a transfer to an investment company only if the transfer results, directly or indirectly, in diversification of the transferor's interests. Treas. Reg. §1.351-1(c)(5) provides that if there is only one transferor to a newly organized corporation, the transfer will generally be treated as not resulting in prohibited diversification. Where, as in the instant case, there is a single transferor, we see no reason to differentiate between a newly formed corporation or a pre-existing corporation, such as Corp, because the transferor's interest in the aggregate of the assets, i.e. those within the corporation and those contributed to the corporation remains unchanged. Therefor, we believe that it is more likely than not that Investor's contribution of Financial Assets to Corp would not be treated as not a transfer to an investment company that is subject to Code Section 351(e).

Based on the foregoing, it is more likely than not that the contribution by Investor of the Financial Assets to Corp would qualify as an exchange described in Code Section 351(a) on which Investor would recognize no gain or loss.

It is possible that the IRS might argue, and in certain cases it has been suggested, that a Code Section 351 transfer will be respected for tax purposes only if it has a "business purpose." See, e.g., Rev. Rul. 55-36, 1955-1 CB 340; West Coast Marketing Corp. v. Comm'r, 46 TC 32 (1966). See also, Estate of Kluener v. Comm'r, 154 F3d 630 (6th Cir. 1998), aff'g in part and rev'g in part T.C. Memo-1996-519, in which the Tax Court determined that, where a shareholder contributed horses to a controlled corporation which sold the horses and distributed the proceeds to the shareholder, there was no business purpose for the transfer, and as a result Code Section 351 would not apply and that the correct way to view the transaction was to treat the corporation as a conduit for the shareholder in effecting the sale, i.e. to disregard the transfer to the corporation entirely. Although the discussion of business purpose for the transaction was couched in terms of the applicability of Code Section 351, the decision does not address whether in the absence of such a business purpose would a non-taxable exchange become taxable, but

rather whether there was sufficient substance to the transactions to recognize the existence of the corporation in the first place.

It should be noted that, the Treasury Regulations promulgated under Code Section 351 do not require such a purpose. This should be compared to the Treasury Regulations relating to qualification of a transaction as a tax-free reorganization. See Regs. § 1.368-1(b). As discussed below, we believe that it is more likely than not that the Transactions would have the requisite business purpose because of their economic substance. Because the consideration that Investor received on the contribution (i.e., the increase in value of Corp) was equal to the fair market value of the transferred Financial Assets, and the Corp stock that Investor received provided Investor with an opportunity to profit from such ownership, it is more likely than not that the IRS would not be successful were it to argue that the transfer of the Financial Assets to Corp should be denied Code Section 351 treatment because of the absence of a business purpose. Furthermore, were the IRS successful, it is more likely than not that any loss on such contribution would have to be recognized by Investor. See, Treas. Reg. §1.1001-1; Cottage Savings Association v. Comm'r, 499 U.S. 554 (1991).

2. **Code Section 358**

Code Section 358(a)(1) provides that in the case of an exchange to which Code section 351 applies, the tax basis of the nonrecognition property received (in the instant case, Investor's stock in Corp) equals (or is increased by) the tax basis of the property exchanged (i.e., Investor's interest in Partnership. Under Code Section 358(a)(1)(A), this amount is decreased by the amount of any money received by the transferor, and Code Section 358(d) provides that the assumption of a liability by the transferee or the transfer of assets subject to a liability is treated as a distribution of money. Consequently, it is more likely than not that Investor's tax basis in Investor's Corp stock is increased by the amount of Investor's tax basis in the Financial Assets.

3. **Code Section 362**

Code Section 362(a) provides that if property is acquired by a corporation in a transaction to which Code 351 applies or as a contribution to capital, then the basis of such property is the same as it would be in the hands of the transferor, increased by the amount of gain (if any) recognized by the transferor on such transfer. Based on Code Section 362(a), it is more likely than not that Corp's basis in Investor's interest in the Financial Assets would equal Investor's tax basis therein.

H. Disposition of the Financial Assets

Investor has represented that the Financial Assets are capital assets in Investor's hands and in the hands of Corp. Under Code Section 1001(a) a taxpayer recognizes gain or loss from the sale of an asset equal to the difference between the taxpayer's adjusted basis in such asset and the amount realized by the taxpayer from its sale or other disposition. Under Code Section 1222(1)-(4), gain or loss from the sale or exchange of a capital asset is a capital loss. Based on the forgoing, it is more likely than not that the amount of loss recognized by Investor on its disposition of the Financial Assets would constitute a capital loss.

I. Rules Relating to the Limitation of Deductions

It is possible that the IRS also may attempt to assert that one or more of the following apply to the Transactions.

1. Sham Transaction, Economic Substance, and Business Purpose Doctrines

There are innumerable cases addressing the judicially developed doctrines of "sham transaction", "business purpose", and "economic substance". One of the most recent attempts to synthesize these cases appears in "Appendix II To JCX-82-99: Description and Analysis of Present-Law Rules and Recent Proposals Relating to Corporate Tax Shelters", Prepared by the Staff of the Joint Committee On Taxation, JCX-84-99, November 10, 1999 ("JCT Appendix").

(a) "Sham Transaction Doctrine"

With respect to the "sham transaction doctrine", the JCT Appendix describes two types of "shams", "shams in fact" and "shams in substance". The first involves transactions that in fact never occur. As an example, the JCT Appendix cites Goodstein v. Comm'r, 267 F.2d 127 (1st Cir. 1959), in which assets were never purchased and a loan never incurred by the taxpayer. It is more likely than not that the Transactions would not constitute one or more "shams in fact", based upon the advise of Managers that every transaction did in fact occur as described in Part I hereof.

With respect to the "sham in substance" aspect of the doctrine, the JCT Appendix II cites Yosha v. Comm'r, 861 F.2d 494 (7th Cir. 1988) as an example. In Yosha, the taxpayers entered into a series of transactions on the London Metals Exchange ("LME") that were not "shams in fact" because they actually occurred. The taxpayers, however, were fully protected

against loss through arrangements by the promoter with the LME brokers, and the transactions were structured so that the taxpayers could not earn a profit from them, i.e., as an economic matter the trades were voided although as a legal and factual matter they occurred.[15] Thus the taxpayers were in the position of economically, or "in substance", never having entered into the transactions. A similar analysis is applied in determining whether a taxpayer is the owner for U.S. federal income tax purposes of a particular asset. Thus, if the taxpayer has none of the economic risk of an owner and none of the economic benefits of an owner, the taxpayer would ordinarily not be treated as the owner, i.e., the taxpayer's economic ownership is voided, and such situations could be viewed as "shams in substance".

In the instant case, neither Investor nor Fund entered into arrangements that voided the economic effects of any of the Transactions. Consequently, it is more likely than not that the Transactions would not constitute one or more "shams in substance". Much confusion about the sham transaction doctrine has arisen because the courts often treat transaction that fail the "economic substance" or "business purpose" doctrines " as "shams". In this regard, the JCT Appendix notes:

> [T]he delineation between [the sham transaction] doctrine (particularly as applied to "shams in substance") and the "economic substance" and the "business purpose" doctrines...is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" not withstanding that the purported activity did actually occur.

JCT Appendix at n. 23.

(b) <u>Economic Substance and Business Purpose Doctrines</u>

As with the relationship of the sham transaction doctrine to the business purpose and economic substance doctrines, there is some confusion about the relation of the latter two to each other. Again, the JCT Appendix is helpful in trying to clarify the confusion:

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15 Because the arrangements to protect against loss were arranged by the promoter, the court was not faced with addressing the effect of bona fide hedging transactions with unrelated parties. Hedges provided by a party involved in the transactions was also viewed as a negative factor in ACM Partnership v. Comm'r, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F3rd 231 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

> In its common application, the courts use business purpose (in combination with economic substance...) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and (2) the transaction lacks economic substance. [citation omitted]

JCT Appendix, at n. 63. This language mirrors the language of the Fourth Circuit Court of Appeals in Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89 (4th Cir. 1985).[16] Consequently, to determine whether the Transactions will be respected in the instant case one needs to test the transactions under each prong. The Transactions will not be respected for U.S. federal income tax purposes only if they fail both prongs, i.e., the Transactions lack both business purpose and economic substance.

i. Business Purpose

For a transaction to have a business purpose, there must be a business or commercial reason for the taxpayer to engage in the transaction without regard to tax benefits. Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989); Rice's Toyota World, Inc. v. Comm'r, supra. The existence of such a purpose was recently addressed in United Parcel Service of America, Inc. v. Comm'r, T.C. Memo. 1999-268.

In the United Parcel Service case, the taxpayer tried to avoid taxation with respect to certain fees by restructuring them as insurance. Economically, the taxpayer was in substantially the same position as before the restructuring, but through the arrangements was able to exclude the payments from income. The taxpayer put forth a number of commercial reasons for the restructuring of the fees. The taxpayer argued that (i) it was required to restructure the arrangements because such payments would fall afoul of restrictions under some state insurance laws; (ii) it intended to leverage the profits into the creation of a new reinsurer that could become a full-line insurer; (iii) by removing the fees from its operating ratios it could obtain larger rate increases than had it received the fees directly; and (iv) by restructuring the fees it protected its

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16 "To treat a transaction as a sham the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists." Rice's Toyota World, Inc. v. Comm'r, 752 F.2d at 91.

transportation business from the risk increased liabilities. However, the taxpayer offered no credible evidence that the restructuring would in fact achieve goals (i), (iii), and (iv). The court also found that goal (ii) could have been accomplished by merely making an investment in such a reinsurer.

Similarly, in Winn-Dixie Stores Inc. v. Comm'r, 113 T.C. No. 21 (1999), the court disallowed interest deductions on policy loans in a COLI program that insured the lives of approximately 30,000 workers. The program resulted in a pre-tax loss for the taxpayer. The taxpayer argued that the program (i) enabled it to fund costs of one of it benefit programs, and (ii) increased the benefits it could offer to its employees. As to (i), the court found that there was no contemporary evidence that it had purchased the COLI policies to provide such funding; that the COLI policies were not designed to fund such benefits; that the taxpayer's CFO never told the entity that was planning the COLI transactions that the purpose was to fund the benefit program; and that projections showed that the cash flow from the program was needed to pay future interest and premiums as opposed to being available to fund the benefits plan. As to (ii), the court found that the described additional benefits were not related to the COLI program.

In Compaq Computer Corp. v. Comm'r, 113 T.C. 214 (1999) the court disallowed foreign tax credits associated with dividends on certain American Depositary Receipts. Among the factors taken into account was that the officer of the taxpayer in charge of the investments made no inquiry into the commercial aspects of the transactions.

Lastly, in ACM Partnership v. Comm'r, supra, and Saba Partnership v. Comm'r, T.C. Memo. 1999-359, involving similar transactions, the courts found that the business purposes of the transactions were unsupported by the evidence and, similar to the foregoing cases, the individuals involved with execution of the transaction did not exhibit behavior consistent with trying to achieve the purported commercial purposes.

The common thread in these cases is that to have the requisite business purpose to support the tax benefits achieved, there must be a purported commercial reason for engaging in the various transactions, the transaction must be consistent with such reason, and such reason must be supportable by contemporary evidence, including a showing that the transaction was handled in a business-like manner. This analysis is supported by a number of cases.

For example, in Levy v. Comm'r, 91 T.C. 838 (1988), the taxpayers entered into a sale-leaseback of computer equipment for the asserted reason of diversifying their business and investments. In upholding the tax benefits the court stated:

> Based upon our careful examination of the relevant facts and evidence in this case, we conclude that petitioners entered into the transaction in issue for sound business reasons (namely to diversify their investments by entering into a legitimate long-term investment involving the purchase and leaseback of computer equipment). Petitioners approached the decision to enter into this transaction in a businesslike manner. Petitioner's financial advisor thoroughly and in good faith investigated the proposed purchase-leaseback transaction. He prepared cash flow analyses which included the components of the transaction that were critical to earning a profit on the investment. Those components included the current fair market value and projected residual value of the equipment, the fair rental value of the lease, and the rent participation agreement. He explained to petitioners the significance of and risks associated with the projected residual value of the equipment and the rent participation agreement. In addition, he explained to petitioners the tax consequences of the transaction. Petitioners also retained a law firm with expertise in leasing transactions to investigate the financial status and creditworthiness of each participant involved in the transaction, to investigate each participant's business reputation, and to handle the legal aspects of this complex transaction.
>
> We are satisfied that petitioners had a good faith and substantial business purpose for entering into the transaction. Petitioners participated in the purchase leaseback transaction only after they were convinced that the investment had a reasonable possibility of producing a profit.

91 T.C. at 855-856. See also, Pearlsten v. Comm'r, T.C. Memo. 1989-621; Rubin v. Comm'r, T.C. Memo. 1989-484.

In Caruth Corp. v. Comm'r, 865 F.2d 644 (5th Cir. 1989), aff'g 688 F. Supp. 1129 (N.D. Tex. 1987), the issue was whether a charitable contribution would be allowed for a contribution of stock of a controlled corporation after the dividend was declared, but before the

dividend record date. The court upheld the deduction in part upon finding that lag between the declaration and record dates had a business purpose:

> [Taxpayer] contends that the distinction between the two dates was designed to encourage his nephews… to sell their shares to him….The lag between the declaration and record dates was designed to give the nephews an opportunity to sell. The plan failed in this respect; the nephews held their shares.
>
> The district court made factual findings that the [taxpayer] wished to buy out his nephews' interests in North Park Incorporated, and that he believed declaration of a dividend might facilitate this objective. We review these findings pursuant to the clearly erroneous standard, and find clear support in the record. With these factual findings in place, we believe it obvious that the distinction between declaration and record date did, as [taxpayer] contends, serve a legitimate business purpose.

865 F.2d at 650.

Lastly, it should be noted that a transaction can have an appropriate business purpose even if the transaction itself does not generate a profit. For example, in Chisholm v. Comm'r, 79 F.2d 14 (2nd Cir. 1935), cert. denied 296 U.S. 641 (1935), the court held that the desire to pool and jointly manage assets was adequate business purpose to own and manage such assets through a partnership. See, Caruth v. Comm'r, supra; Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992).

As stated above, Investor believed that Investor had a reasonable opportunity to earn a reasonable profit, in excess of all fees and transaction costs, from the Transaction, without regard to tax benefits. Also as stated above, Investor contributed the Options to Fund for substantial non-tax business reasons, including diversification of its portfolio without the need for additional investment, the professional management provided by the Managers, and the desire to create larger pool of capital through the involvement of other investors such as the Managers. These reasons would more likely than not satisfy any business purpose requirement for Investor's entering into the Transactions in the first instance and for contributing the Options to Fund. The IRS might assert that Investor could have accomplished the same result by contributing cash to Fund and having Fund acquire the Options, and that there was no business purpose for the form chosen by Investor. However, long-standing judicial authority has also

recognized that "any one may so arrange his affairs that his taxes shall be as low as possible". Helvering v. Gregory, 69 F. 2d 809 (2d Cir. 1934). Therefore, a taxpayer is free to choose the most tax-favored method of accomplishing an economic result without any business justification for the method chosen, so long as that method is no more circuitous than another and the transaction itself has the requisite business purpose.

ii. Economic Substance

It is well established that a transaction or series of transactions may not be respected for tax purposes unless the transaction or transactions have economic substance separate and distinct from the economic benefit derived from tax reduction. Gregory v. Helvering, 293 U.S. 465 (1935). Transactions failing to meet this standard lack the requisite "economic substance" (often interpreted as a having a reasonable possibility of pre-tax profit) and so will not be respected for tax purposes. However, the Supreme Court has held that a transaction should be respected if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. U.S., 435 U.S. 561, 583-584 (1978). Thus, transactions have been upheld where they were designed to achieve a tax benefit, but were endowed with positive pretax economics. See, e.g., Northern Indiana Public Service Co. v. Comm'r, supra.

The Yosha decision articulated the standard slightly differently:

> A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages—may indeed have had no other interest in the transaction."

Yosha v. Comm'r, supra, 861 F.2d at 499.

It should be noted that a taxpayer need not be correct in its judgment of possible economic benefits, only reasonable or rational. Profit motive depends on the taxpayer's subjective and good faith intent to earn a profit. Finoli v. Comm'r, 86 T.C. 697, 722 (1986). The fact that a venture fails to produce a profit in the anticipated amount or at all does not indicate that the venture was not profit-motivated. King v. U.S., 545 F.2d 700, 708 (10th Cir.

1976). However, that profit potential cannot be illusory. In ACM Partnership v. Comm'r, supra, the Tax Court found that at the time it entered into the partnership, the taxpayer's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of certain notes, or a 400-500 basis point increase in 3-month LIBOR interest rates. The court found no impact on credit quality was possible as the lenders were extremely highly rated at the time of the transaction. Moreover, the court did a 6-year review of 3-month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame. Since the analysis of the historical data showed no reasonable basis for expecting a profit, the court ruled against the taxpayer. "We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance". 873 T.C.M. (CCH) at ___. In its analysis, the Third Circuit focused upon the foregoing finding of the Tax Court, stating:

> Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations.

157 F.3d at 252. The Third Circuit also noted:

> [O]n November 3, 1989, [the partnership] invested $175 million of its cash in private placement Citicorp notes paying just three basis points more than the cash was earning on deposit, then sold the same notes 24 days later for consideration equal to their purchase price, in a transaction whose terms had been finalized by November 10, 1989, one week after [the partnership] acquired the notes. These transactions . . . offset one another and with no net effect on [the partnership]'s financial position.

See also, Saba Partnership v. Comm'r, supra; Merryman v. Comm'r, 873 F.2d 879 (5th Cir. 1989) (conduit partnership without economic substance disregarded).

In Compaq Computer Corp. v. Comm'r, supra, in addition to finding no business purpose for the transactions, the Tax Court also found a lack of economic substance. This was

because as the transactions were designed and executed, the taxpayer was bound to suffer a pre-tax loss. The Tax Court reached a similar conclusion for the same reason in Winn-Dixie Stores Inc. v. Comm'r, supra.

From these cases it appears that the "substance" necessary to meet the requirements of the "economic substance" doctrine is somewhat different from the "substance" required under the "sham in substance" doctrine. As discussed above, the latter requires that the transaction have the economic consequences consistent with what the transaction purports to be: Does the taxpayer really have the economic incidents of ownership if the taxpayer purports to own the asset? The former requires that, having passed the "sham in substance" test, the transaction make economic sense: Does the taxpayer have a reasonable possibility of economically benefiting from the transaction without regard to tax benefits?

Sheldon v. Comm'r, 94 T.C. 738 (1990), is inconsistent with the economic substance cases in its suggestion that there must be not only a reasonable possibility of making a profit, but also the possibility must relate to a profit that is greater than de minimis.[17] A handful of other decisions have indicated in the context of Code Section 165(c)(2), discussed below, that the court should consider whether the profit motive for a transaction was greater or less than the tax motive. See, e.g., Fox v. Comm'r, 82 T.C. 1001 (1994); Estate of Baron v. Comm'r, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986). However, to date these cases appear to represent a minority view. Thus, tax benefits achieved in a transaction should not be denied under the economic substance doctrine merely because the transaction's principal purpose was to achieve such tax benefits. See, e.g., Northern Indiana Public Service Co. v. Comm'r, supra. Congress has precluded such a broad test for all disallowance by incorporating such a principal purpose test into specific Code Sections such as Code Section 269. Long-standing judicial authority has also recognized that "any one may so arrange his affairs that his taxes shall be as low as possible". Helvering v. Gregory, 69 F. 2d 809 (2d Cir. 1934). See also, Cottage Savings

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17 On December 23, 1997, the IRS issued Notice 98-5, announcing that the IRS will issue regulations effective on and after such date dealing with foreign taxes paid or accrued in connection with certain abusive transactions. Such transactions were described as those in which the anticipated economic benefits are insubstantial in relationship to the anticipated tax benefits. It is currently uncertain as to when or whether such regulations will be issued, the criteria they will establish with respect to the insubstantiality of anticipated economic benefits, or whether such regulations will have application beyond the area of foreign taxes.

Association v. Comm'r, 499 U.S. 554 (1991), upholding tax benefits achieved by a transaction executed solely for tax purposes.

In Notice 99-59, 1999-52 IRB 1 (December 9, 1999), the IRS announced that it would challenge "certain types of transactions" designed to generate a non-economic tax loss. The IRS stated that the transactions are "cast in a variety of forms". In one "typical arrangement", a partnership contributes capital to a newly-organized foreign corporation, which borrows a roughly equal amount from a bank. The corporation acquires securities with the loan proceeds, and then distributes these securities to the partnership as a dividend, thus reducing the value of the corporation to zero. However, since the dividend is paid subject to the bank debt, the amount of the distribution is treated as zero, so the partnership recognizes no income and retains his original basis in the corporation's shares. Ultimately, the corporation pays off the bank debt with the proceeds of the original capital contribution, and the partnership disposes of the shares of the corporation, recognizing a tax loss equal to the amount of the original capital contribution even though economically the partnership is back where it started. The IRS concluded that "In the view of the Service and the Treasury Department, the arrangement described above (or any similar arrangement) does not produce an allowable loss." The Transactions are factually wholly unlike the arrangement described in Notice 99-59, are based on entirely different tax principles, and so are not a "similar arrangement".

Lastly, in Salina Partnership LP, FLP Group, Inc. v. Comm'r, supra, a partnership had been previously formed by an investment bank and made a series of investments. Understanding from the investment bank that the purchase of 50% or more of the interests in the partnership would provide certain tax benefits, the taxpayer purchased 98% of the outstanding partnership interests. The IRS conceded that the partnership was profitable and such profitability provided the taxpayer with sufficient profit motive to imbue the *post-purchase portion* of the transaction with economic substance. However the IRS contended that the pre-purchase part of the transactions did not have sufficient economic substance and, accordingly the taxpayer's tax benefits achieved through the transaction should be denied. The court stated that although the purchase of the partnership interest provided the taxpayer with a perceived tax benefit, "this factor, standing alone, is insufficient to render the transaction a sham in substance." The court found that the investment in the partnership provided the taxpayer with a reasonable opportunity to earn profits independent of tax benefits, and that such opportunity imbued the entire transaction with a sufficiently valid business purpose to give the transaction the economic substance necessary to be respected.

(c) **Conclusion**

Based upon the representations provided by Investor in II, above, it is more likely than not that the Transactions will have the requisite economic substance and business purpose to be respected under the authorities discussed above.

2. **Code Section 165**

(a) **In General**

Code Section 165(a) provides:

> There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by deduction or otherwise.

Treas. Reg. §1.165-1 further provides that for the loss to be allowable under Code Section 165(a) the loss must be evidenced by closed and completed transactions, fixed by identifiable events, and be actually sustained during the taxable year; that the loss be a bona fide loss; and that substance rather than form should govern. The loss arising in connection with the Transactions is evidenced by closed and completed events and fixed by an identifiable event, the liquidation of Investor's interest in Fund, and as discussed above, it is more likely than not that the loss will be treated as being bona fide (as opposed to being treated as a sham) and as having sufficient economic substance to be sustained. Consequently, it is more likely than not that the loss from the Transactions would meet the requirements of Code Section 165(a).

However, it is possible that the IRS would contend otherwise. In Rev. Rul. 2000-12, 2000-11 IRB 1, Situation 1, a corporation purchased two privately placed debt instruments from unrelated issuers for $1,000,000. The notes bore interest at a fixed rate adjusted for a contingency as of a reset date. In the case of one note, if the contingency occurred, the interest rate would double, but if it did not occur, the interest rate would be reduced to zero. In the case of the other note, the effects of the contingency were reversed. As a result, at the time the notes were purchased, based upon their structure on the reset date it could be expected that the value of one note would increase while the value of the other note would decrease by approximately the same amount. As a further result, the amount of the tax loss suffered with respect to the note that declined in value significantly exceeded the amount of the economic loss suffered by the taxpayer on the two notes. Thus, the Ruling compared the tax loss on one instrument to the economic loss from the combined position. The Ruling concluded that the loss on the note that

declined in value was not allowable because it did not reflect actual economic consequences. As support for its position, that such a loss was not "bona fide" and did not reflect "actual economic consequences", the Ruling cited ACM Partnership v. Comm'r, supra; Scully v. U.S., 840 F.2d 478 (7th Cir. 1988); and Shoenberg v. Comm'r, 77 F.2d 446 (8th Cir.) 1935). See also, Notice 99-59, 1999-52 IRB 761, and Notice 2000-44, 2000-36 IRB 1, discussed in detail below, in which the IRS took the same position in reliance on the same authorities. In addition, the Ruling cited Lerman v. Comm'r, 939 F.2d 44 (3rd Cir. 1991), cert. denied, 502 U.S. 984 (1991) , and Keane v. Comm'r, 865 F.2d 1088 (9th Cir. 1989).

In ACM Partnership v. Comm'r, supra, the Third Circuit Court of Appeals did in fact adopt the concept of a bona fide loss. However, the taxpayer in ACM acknowledged in its own submissions that the transaction was structured so that the securities in issue were purchased and sold at the same price. The Court of Appeals stated:

> As the Supreme Court emphasized in Cottage Savings, deductions are allowable only where the taxpayer has sustained a "bona fide " loss as determined by its "[s]ubstance and not mere form." According to ACM's own synopsis of the transactions, the contingent installment exchange would not generate actual economic losses. Rather, ACM would sell the Citicorp notes for the same price at which they were acquired, generating tax losses which offset precisely the tax gains reported earlier in the transaction with no net gain or loss from the disposition. Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses do not constitute the type of "bona fide" losses that are deductible under the Code and regulations. [citations omitted]

Thus, the Court of Appeals denied the allowance of a loss arising from the purchase and sale of a security in a manner akin to a "repo" or a "reverse repo" transaction, which is generally treated as a lending transaction rather than a sale upon which gain or loss is recognized.

To try to get an understanding of the Court of Appeals' concept of a bona fide loss it is useful to examine footnote 31. Footnote 31 provides:

> While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences

> must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, its is also well established that where a transaction objectively affects the taxpayers net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. See, e.g., Gregory, 293 U.S. at 468-69, 55 S. Ct. at 267 ("if a reorganization in reality was effected… the ulterior purpose will be disregarded"), Northern Indiana Pub. Serv. Co., 115 F.3d at 512 (emphasizing the Gregory and its progeny "do not allow the Commissioner to disregard economic transactions…which result in actual, non-tax-related changes in economic position" regardless of tax avoidance motive" and refusing to disregard role of the taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit); Kraft Foods Co. v. Comm'r, 232 F.2d 118, 127-128 & n. 19 (2d Cir. 1956) (refusing to disregard tax effects of debenture issue which "affected … legal relations" between taxpayer and corporate parent by financing subsidiary's acquisition of venture used to further its non-tax business interests). In analyzing both the objective and the subjective aspects of ACM's transaction in this case where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations.

In the instant case, as discussed above, the Transactions were motivated by non-tax reasons and so more likely than not would not be treated as "shams in substance", and none of the transactions occurred at predetermined prices that would insure no economic change of position for Fund, as was the case for the so-called Citicorp notes in the ACM case. Consequently, it is more likely than not that the reasoning set forth in ACM for concluding a loss is not "bona fide" would not be applicable to the loss sustained from the Transactions.

Rev. Rul. 2000-12, supra, also cited Scully v. U.S., supra, and Shoenberg v. Comm'r, supra, for the proposition that the losses described in the Ruling were not "bona fide". In Scully, the Seventh Circuit Court of Appeals held that there was no deductible loss involving the sale of real estate by trustees of the family trust to other family trusts with the same

fiduciaries, beneficiaries and remaindermen. This disposition merely resulted in a reshuffling of assets which resulted in no "genuine economic loss" because the taxpayer retained control over the property – i.e., the sale was effectively a circular transaction with no economic substance. Citing from 7J. Mertens, Law of Federal Income Taxation §28.26 (1980), the Court of Appeals relied upon the following principle for its conclusion that the loss incurred on the sale of the real estate was not deductible:

> Losses will not be allowed which are claimed in connection with transactions which do not vary control or change the flow of economic benefits....[A taxpayer] will not be permitted to transfer assets from one pocket to another and take a loss thereby where he remains at the conclusion of the transfer the real owner of the property, either because of retention of title, command over the property, either directly or through the person who appears as the nominal vendee or transferee.

In the instant situation, Fund did not continue to own, beneficially or otherwise, the asset, i.e. the Bonds, the disposition of which generated a loss. Accordingly, the reasoning set forth in Scully for denying a loss deduction, is not applicable to the loss sustained from the Transactions.

In Schoenberg, the Eighth Circuit Court of Appeals held that there was no deductible loss where an investor sold stock at a loss and on the same day bought the same number of identical shares through his investment company. A little more than thirty days later, the investor purchased the shares from his investment company at a lower price than that for which he had originally sold them. The Court of Appeals denied the investor's loss deduction, stating that :where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and substantial; it is not real." Economically, the transaction was again a circular transaction with no economic substance. Schoenberg, like Scully, is a case in which the court held that a loss was not realized by the taxpayer because the taxpayer held the same beneficial interest in the purportedly sold assets both before and after the sales. As previously stated, in the instant situation Fund did not continue to own, beneficially or otherwise, the asset the disposition of which resulted in a loss. Accordingly, the reasoning set forth in Schoenberg for denying a loss deduction also is not applicable to the loss sustained from the Transactions.

Rev. Rul. 2000-12, supra, also cited Lerman v. Comm'r, supra, and Keane v. Comm'r, supra, for the proposition that courts have disallowed loses from option straddle

transactions that were found to be devoid of economic substance, where the trades were prearranged to generate a loss for tax purposes while deferring offsetting gain. These cases are only two of many involving the so-called "London option transactions". In each of the cases in which the loss was denied, the denial was based upon the inability of the taxpayer to make a profit from the transaction, i.e. that the transactions did not meet the standards, discussed above, regarding economic substance and business purpose In the instant situation, it is more likely than not that the Transactions did have the requisite economic substance and business purpose. Accordingly, the reasoning set forth in these case for denying a loss deduction also is not applicable to the loss sustained by Investor in the Transactions.

Furthermore, there is no support for the implication in Rev. Rul. 2000-12, supra, that the mere existence of offsetting position means a loss is not "bona fide". Code Section 1256 was added Code Section 1256 to the Internal Revenue Code by the Economic Recovery Tax Act of 1981. Among other reasons stated in the General Explanation of the Economic Recovery Tax Act of 1981 (the "General Explanation"), Congress enacted Code Section 1256 "to prevent taxpayers from claiming the tax benefits which were allegedly obtained by using a futures straddle as a tax shelter." Thus, Code Section 1256 was enacted to address the abuse that the courts sought to address in the "London option transactions" cases. It did so not through an outright disallowance of any losses inherent in such positions, but rather by accelerating the tax consequences of holding such positions by marking to market the positions at the close of the taxable year or upon certain other events. Thus, in those situation in which the offsetting positions are entered into with the requisite economic substance and business purpose, it would appear that losses arising from the offsetting positions should be allowed unless they are restricted by Code Section 1256. Code Section 1092 was also adopted by the Economic Recovery Tax Act of 1981 to deal with offsetting positions. The Tax Court in Smith v. Comm'r, 78 T.C. 350 (1982) aff'd without published opinion 820 F.2d 1220 (4th Cir. 1987), refused to find a non-statutory wash sale rule that would deny the losses and looked to the adoption of Code Section 1092 by the Economic Recovery Tax Act of 1981 as evidence that the mere existence of offsetting positions was not enough to deny a loss. Although ultimately finding for the IRS and against the taxpayer, the losses were denied on the grounds that there was an absence of a sufficient profit motive. Accordingly, it is more likely than not that the mere existence of offsetting positions would not be enough to allow the IRS to successfully contend that a loss arising therefrom is not "bona fide"

Based upon the foregoing, it is more likely than not that the loss sustained from the Transactions would be allowable under Code Section 165(a).

(b) Code Section 165(c)(2) and Code Section 183

Notwithstanding that the loss sustained from the Transactions meets the requirements of Code Section 165(a) and the Transactions have the requisite economic substance and business purpose, Code Sections 165(c) and 183, impose additional limitations on the ability of individuals[18] to claim losses. Code Section 165 applies to loss deductions, and Code Section 183 applies to all deductions. If an individual incurs a loss from the disposition of assets in the individual's trade or business or in a transaction entered into for profit, Code Sections 165(c) and 183 generally permit the allowance of such loss.

If an individual incurs a loss in the individual's trade or business, Code Section 165(c)(1) generally permits the allowance of such loss. In determining whether such a business exists, the courts have required that the criteria of Code Section 183 be met. See, Farmer v. Comm'r, T.C. Memo 1994-342. The determination of whether a transaction has been undertaken for profit for purposes of Code Section 183 is based on all the facts and circumstances. Treas. Reg. §1.183-2(b) lists nine specific factors that are to be taken into account in making this determination. This regulation also provides that "[a]lthough a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity... with the objective of making a profit." While there has been substantial litigation regarding whether such motive exists, the cases have established that a taxpayer need only have a good faith expectation of earning a profit from the activities undertaken. See, e.g., Burger v. Comm'r, 809 F.2d 355 (7th Cir. 1987); Johnson v. U.S., 11 Cl. Ct. 17 (1986).

If an individual incurs a loss in a transaction which does not involve the individual's trade or business, Code Section 165(c)(2) and Treas. Reg. §1.165-1(e) require, like Code Section 183(a) and Treas. Reg. §1.183-1, that the loss be incurred in a transaction entered into for profit. Thus, these statutory and regulatory provisions mirror the Code Section 183 standard.

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18 In the case of a partnership (or entity treated as a partnership) Code Section 165(c)(3) is applied at the partnership level.

Notwithstanding the parallel nature of Code Section 183(a) and Code Section 165(c)(2), some courts have imposed a judicial gloss that appears to create a standard higher than that imposed by the statutes, i.e., that the taxpayer's profit motive be the "primary" motive for entering into the transaction. The first case that did so was Fox v. Comm'r, supra. The Tax Court in Fox derived this primary profit motive test from a footnote in Helvering v. National Grocery Co., 304 U.S. 282, 289 n.5, reh'g denied, 305 U.S. 669 (1938), which involved the constitutionality of the accumulated earnings tax. The footnote stated in relevant part:

> Similarly, the deductibility of losses under [Code Section 165(c)(2)] may depend upon whether the taxpayer's motive in entering into the transaction was *primarily profit*. [Emphasis added.]

In addition, the Tax Court in Fox relied on an earlier Tax Court case involving the deductibility of a loss under Code Section 165(c)(2), Smith v. Comm'r, supra. In Smith, however, the Tax Court did not impose the "primary" test articulated in Fox, but rather stated at p. 391:

> The mere fact that petitioners may have had a strong tax avoidance purpose in entering into their commodity tax straddles does not in itself result in a disallowance of petitioners' losses under section 165(c)(2), provided petitioners also had a non-tax profit motive for their investments at the time, See, Knetsch v. United States, 172 Ct. Cl. 378, 348, F. 2d 932, 936-937 (1965). Such hope of deriving an economic profit aside from the tax benefits *need not be reasonable so long as it is bona fide*. See, Bessenyey v. Commissioner, 45 T.C. 261, 274 (1965), aff'd 379 F.2d 252 (2nd Cir. 1967). [Emphasis added.]

Both the Fox and Smith cases, as well as the bulk of subsequent cases involving the application of the "primary" standard, arose in connection with commodities straddle transactions in which looking at the transactions as a whole, the taxpayer had little or no opportunity to earn any meaningful profit.[19] Neither the Knetsch case nor the Bessenyey case

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19 The Tax Court in Sheldon v. Comm'r, supra, applied these principles where in certain of the transactions before the Court the taxpayer demonstrated that it could have made a profit. The Tax Court denied the claimed deductions stating that: "[i]n instances where intermediate repos would have or did generate some form of [positive] carry, these amounts were nominal, either fixed or short term and stable and, in any event

cited by the Tax Court in Smith required the profit motive of the taxpayer to be the primary standard for engaging in the transactions in issue, although the Knetsch decision did refer to the National Grocery Co. Supreme Court decision discussed above.

When a court has thoughtfully attempted to deal with the "primary" standard, the results have often yielded confusion. For example in Nickeson v. Comm'r, 962 F.2d 973, 976 (10th Cir. 1992), a case involving the application of Code Section 183, the court first appeared to apply the primary standard by requiring that the taxpayer engage in the transaction with the "dominant hope and intent to realizing a profit", but then went on to provide that "the determination crucial to the instant case [is]-whether the taxpayers had an actual and honest profit objective." See also, Nickerson v. Comm'r, 700 F.2d 402, 404 (7th Cir. 1973).

This confusion may be due in part to the fact that in Fox v. Comm'r, supra, which first applied the primary standard in the context of Code Section 165(c)(2), the taxpayers had little or no opportunity to make more than a relatively small fixed economic profit from the commodity straddle transactions into which the taxpayer entered. Such a situation is unlike the instant case in which, based on the Representations from Investor, based on Investor's own independent evaluation, Investor believed that Investor had a reasonable opportunity to earn a reasonable profit, in excess of all fees and transaction costs, from the Transactions, without regard to tax benefits.. Such a profit potential is more analogous to the situation in Smith v. Comm'r, supra. Consequently, based on the Summary at I, above, the Representations at II, above, and the rationale applied in Smith v. Comm'r, supra, it is more likely than not that the requisite profit motive would exist to support the deduction of any loss arising to Investor from the Transactions under Code Section 165(c)(2) and under Code Section 183.

(c) Notice 2000-44

i. Description of Notice 2000-44

On August 11, 2000, the IRS released Notice 2000-44, supra. The Notice describes certain arrangements that the IRS and the Treasury believe "have been designed to produce noneconomic tax losses on the disposition of partnership interests. These arrangements

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merely reduced the fixed losses by relatively insignificant amounts." It should be noted that the Tax Court ultimately found that even what nominal profit there was in Sheldon was absorbed by losses on related and, arguably, integrated transactions. 94 T.C. 738, 768 and 769. See also, Est. of Baron v. Comm'r, supra.

purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests."

One version of the arrangements addressed in the Notice is described as follows:

> [A] taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.
>
> Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

Among other things, the Notice states that "[t]he purported losses resulting from the transaction described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of section 165."

ii. Authority to Issue Notice 2000-44

IRS Notices are issued under the statutory authority of Code Section 7805(a) which states: "the Secretary [of the Treasury]...shall prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code. Furthermore, authority for the issuance of

Notices exists in Treas. Reg. §301.7805-1(a) which states: "[t]he Commissioner [of the Internal Revenue Service], with the approval of the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of the Code ... including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." However, Section 7805(b)(1)(C) of the Code limits the express statutory authority for Notices to those "substantially describing the expected contents of any temporary, proposed, or final regulation."

Under Code Section 7805(b)(1)(C), a proposed, temporary, or final Treasury Regulation may be given retroactive effect to the date on which, among other things, "any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public." It appears that the rationale for granting this statutory authority was to enable the Treasury Department and the IRS to secure retroactive effect for intended future Treasury Regulations by giving notice of its intent to issue such Regulations while affording it the appropriate time to properly substantially and procedurally issue such regulations. Therefore, we believe that the retroactive application of Treasury Regulations to the date of the issuance of the Notice as provided in Code Section 7805(b)(1)(C) requires the Notice to contain some indication of an intent to issue Treasury Regulations. It does not appear that Notice 2000-44 contains such an intent since it neither describes in any detail the contents to be included in a future temporary, proposed, or final regulation nor does it reference any specific intent to issue future regulations under any specific statutory provision. Compare, Notice 97-21, 1997-1 C.B. 407. Consequently, it is at least questionable whether Notice 2000-44 is properly issued under Code Section 7805.

iii. Legal Weight Accorded an IRS Notice

For purposes of the penalty provisions of Code Section 6662, the IRS considers Notices authority that will be binding on the IRS and can be relied on by taxpayers to the same extent as a Revenue Ruling or a Revenue Procedure.[20] Revenue Rulings do not have the force or effect of Treasury Regulations. Treas. Reg. §601.601(d)(2)(v)(d).

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[20] Rev. Rul. 90-91, 1990-2 C.B. 262. It is also important to note that the authority of the IRS to issue Revenue Rulings is derived directly from its regulatory authority. Treas. Reg. §601.201(a)(5) and §601.601(d)(2)(v) define what constitutes a Revenue Ruling and sets forth its effects. With the exception of Code Section 7805(b)(1)(C), there is no such provision, statutory or regulatory, that provides for either the parameters for issuing Notices or their effect. Thus, for the reasons discussed above, we believe that an

There appears to be only one case in which a court weighed the effect to be given an IRS Notice, and in that case the court treated an IRS Notice as if it were a Revenue Ruling. Constantino v. TRW, Inc., 13 F.3d 969, 980-981 (6th Cir. 1994). Even if one assumes the Sixth Circuit's approach of treating a Notice as a Revenue Ruling is correct, there nonetheless exists a lack of uniformity among the courts in their treatment of Revenue Rulings.

As a general matter, the Tax Court is inclined to treat a Revenue Ruling merely as the view of one of the parties to the litigation. See, e.g., Trinova Corp. and Subsidiaries v. Comm'r, 108 T.C. 68 (1997). The Tax Court has stated that it considers a Revenue Ruling to be "advisory only" and a mere "useful guide, outlining some of the factors to be considered" in interpreting the Code. Burck v. Comm'r, 63 T.C. 556 (1975) aff'd 533 F.2d 768 (2d Cir 1976). Rather than giving deference to Revenue Rulings, the Tax Court has treated the rulings as "merely the Commissioner's position with respect to a specific factual situation." Pasqualini v. Comm'r, 103 T.C. 1, 8 n. 8 (1994)(citing Tandy Corp v. Comm'r, 92 T.C. 1165, 1170 (1989)).

The Circuit Courts, however, have struggled with the exact deference, if any, to give to Revenue Rulings. The Fifth Circuit has recognized that "revenue rulings are odd creatures unconducive to precise categorization in the hierarchy of legal authorities. They are clearly less binding on the courts than treasury regulations or Code provisions, but probably (and in this circuit certainly) more so than the mere legal conclusions of the parties." McLendon v. Comm'r, 135 F.3d 1017 (5th Cir. 1998). Likewise, the Third Circuit Court of Appeals has stated that it will "give weight to IRS revenue rulings and [will] not disregard them unless they 'conflict with the statute they purport to interpret or its legislative history, or if they are otherwise unreasonable.'" Gillis v. Hoechst Celanese Corp., 4 F.3d 1137, 1145 (3rd Cir. 1993), cert. denied, 511 U.S. 1004 (1994) (quoting Geisinger Health Plan v. Comm'r, 985 F.2d 1210, 1216 (3rd Cir. 1993). Similarly, in discussing a Revenue Ruling, the Fourth Circuit in Wood noted, without holding, that "it is well established that considerable weight is to be given to an agency's construction of a statute that it is charged with administering." Wood v. Comm'r, 955 F.2d 908, 913 (4th Cir. 1992), cert. dismissed 505 U.S. 1231 (1992). Additionally, the Second Circuit has held that a Revenue Ruling is presumed to "'have the force of legal precedent unless unreasonable or inconsistent with the provisions of the Internal Revenue Code." Gillespie v.

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argument exists that the IRS does not have the requisite authority to bind taxpayers or courts to a Notice, though the IRS is free to bind itself as it did in Rev. Rul. 90-91.

U.S., 23 F.3d 36, 39 (2d Cir. 1994)(quoting Salomon, Inc. v. U.S., 976 F.2d 837, 841 (2d Cir. 1992). However, the Second Circuit's decisions in Gillespie and Salomon, Inc. seem irreconcilable with its statement in Canisius College v. United States that "the statutory interpretation [of] a revenue ruling does not have the force of law and is of little aid in interpreting a tax statute." Canisius College v. U.S., 799 F.2d 18 n. 8 (2d Cir. 1986) cert. denied 481 U.S. 1014 (1987) (citing Dixon v. United States, 381 U.S. 68, 73 (1965); Biddle v. Comm'r, 302 U.S. 573, 582 (1938); Temple University v. United States, 769 F.2d 126, 137 (3d Cir. 1985) cert. denied 476 U.S. 1182 (1986)). The Ninth Circuit followed the Second Circuit's opinion in Salomon, Inc. and afforded Rev. Rul. 82-20 "great deference" where the Ruling was neither unreasonable nor inconsistent with the Code. Walt Disney Inc. v. Comm'r., 4 F.3d 735 (9th Cir. 1993).

Notwithstanding this lack of uniformity among the courts as to what weight, if any, to afford Revenue Rulings, the courts "have not looked favorably upon bootstrapping revenue rulings issued shortly prior to or after the initiation of litigation." Ludwig v. Comm'r, 68 T.C. 979 n. 4 (1977) (citing Fribourg Navigation Co. v. Comm'r, 383 U.S. 272, 279 (1966), rev'g 335 F.2d 15 (2d Cir. 1964); Busse v. Comm'r, 479 F.2d 1147, 1152 n. 12 (7th Cir. 1973)). See also, Silco, Inc. v. U.S., 779 F.2d 282 (5th Cir. 1986).

As a result, the weight given to a Revenue Ruling in litigation will generally depend upon the forum chosen. At best, Revenue Rulings will be given little or no weight and at worst a court will give significant deference to a Revenue Ruling. However, the amount of deference, if any, afforded to a Revenue Ruling by a court will be further dependent upon the context in which it was issued. Moreover, if the Revenue Ruling is issued in connection with litigation, a court that would otherwise give deference to a Revenue Ruling may give it no weight at all. Consequently, were the IRS to contend that Notice 2000-44 were to apply to the Transactions and a court were to treat the Notice as if it were a Revenue Ruling, it is more likely than not that the Notice would not constitute authority that would bind a court, but could be given significant weight by the court in reaching its conclusion and in that case it would have to be distinguished on the basis of fact or by refuting the legal analysis upon which it relies.

iv. Application of Notice 2000-44 and the Authorities cited therein to the Transactions

As support for its position in Notice 2000-44 that the losses described therein were not "bona fide" and did not reflect "actual economic consequences", the Ruling cited ACM